No. 15,299

United States Court of Appeals
For the Ninth Circuit

WALTER J. HEMPY, as Trustee of the Estate of Mechanix, Inc., a corporation, bankrupt,
Appellant,

vs.

JOHN HOWARD SIMS and MARVIN D. MORROW,
Appellees.

APPELLANT'S OPENING BRIEF.

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STATEMENT OF JURISDICTION.

Appellant filed a complaint in the District Court (T.R. p. 4) to recover a preference from Appellees pursuant to the provisions of section 60(b), 11 U.S. C.A. 96(b) of the Bankruptcy Act. The District Court rendered its judgment in favor of Appellees. Pursuant to the provisions of 11 U.S.C.A. 47, Appellant filed his notice of appeal on July 5, 1956 (T.R. p. 13). The appeal was timely filed (11 U.S.C.A. 48).

STATEMENT OF THE QUESTION PRESENTED.

The question before the Court is whether or not the payment of past due salaries to the Appellees, presi-

dent and secretary of a corporation, who were also directors, principal shareholders and the managing officers, within two weeks prior to the filing of a petition in bankruptcy against it constituted a preferential payment. In determining this question two issues must be considered.

(a) Was the corporation insolvent?

(b) Did Appellees have reasonable cause to believe the corporation was insolvent at the time the payment was made?

STATEMENT OF FACTS.

On March 13, 1953 an involuntary petition in bankruptcy was filed against Mechanix, Inc., a corporation, in the United States Court for the Northern District of California in proceeding numbered therein 41488. Subsequently, Mechanix, Inc. was adjudicated a bankrupt. On the 8th day of March, 1953 checks in the sum of $1500.00 each were drawn to the order of John Howard Sims and Marvin D. Morrow, the Appellees, for balances of salary from January 4, 1953 to March 8, 1953 (T.R. p. 25). It was stipulated that at the time these payments were made Appellee, Morrow, was president and Appellee, Sims, secretary of the corporation; that both were directors and shareholders in the corporation; that Appellee, Morrow, was sales manager and Appellee, Sims, plant superintendent, and that between the two of them they operated this business (T.R. p. 18).

ARGUMENT.

I. THE DISTRICT COURT ERRED IN FINDING THAT APPELLEES PROMISED TO CONTINUE IN THE EMPLOYMENT OF MECHANIX, INC., AT THE TIME THEY WERE PAID THIS BACK SALARY.

The District Court made the following findings of fact (T.R. p. 8):

> "(2) That within four months prior to the filing of the petition in bankruptcy against Mechanix, Inc., a corporation, paid to each defendant herein the sum of $1,500.00 which said payment was compensation to each of the said defendants for labor and services rendered to the said Mechanix, Inc., and *that at the said time the said defendants each promised to continue in the employment of Mechanix, Inc.*"; (Italics ours.)

A preference under the Bankruptcy Act takes place when a creditor receives property of a debtor for or on account of an antecedent indebtedness. Section 60 of the Bankruptcy Act, 11 U.S.C.A. 96 so defines it.

> "Section 60. Preferred Creditors. a. (1) A preference is a transfer, as defined in this Act, for any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this Act, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class."

In the trial below Appellees endeavored to introduce testimony that Appellees agreed to keep working for

bankrupt to show a present consideration for the payment of the balance of past due salary to them. The Court after objection by Appellee refused to admit such testimony (T.R. pp. 60-62 incl.).

"Q. (By Mr. Miller.) Mr. Morrow, was it your intention at the time you received this payment on March 8, 1953, to continue in the employ of Mechanix, Inc.?

A. Yes, sir.

(Testimony of Marvin Morrow.)

Mr. Anixter. That is incompetent, irrelevant and immaterial.

A. Yes, sir.

Mr. Miller. I think it is important, your Honor. It could be consideration for the payment as a fact for the Court to consider.

The Court. I would assume that would be the case. Ask another question.

The Witness. I didn't finish my answer.

The Court. Well, I think we have heard enough. I will take it for granted that, whether it is material or not, you were going to continue on in business if you could.

Mr. Miller. Did you want to ask a question, or did you tell me to?

The Court. I will answer it for him.

The Witness. I want to go a little further.

The Court. Well, you weren't going to leave the business, were you?

A. Yes, I was going to leave the company.

The Court. You were?

A. Yes, sir.

The Court. Then I was wrong.

The Witness. I wanted to explain to the Court why.

The Court. Well, what is the materiality of that? Why did you want to bring that out?

Mr. Miller. I think that would be a question of consideration for the payment, your Honor. That's the point I had in mind.

(Testimony of Marvin Morrow.)

The Court. I think there was already perfectly valid consideration for the payment.

Mr. Miller. No, I say as a matter of law, insofar as this proceeding is concerned, a present consideration should take it out of the preference class.

The Court. How could that be when he has already testified it was back payment that was owing from January, $150.00 as a salary.

Mr. Miller. The point is, he received the payment in order to keep him on the job, which would make it a present consideration.

The Court. I don't think I would go into that. I don't see any merit in that. I don't think a man has to say he is going to stay on the job to get some money that is already owing him.

The Witness. I could explain that.

The Court. You don't need to. I don't think it is necessary. It is only a legal question. If money is owing to you, it is owing to you. A man doesn't have to stand on his head to get something that is already owing him.

Mr. Miller. I have no further questions of this witness."

Yet, notwithstanding Court's refusal to receive any evidence on this subject, a finding is made by the Court on this very point. The finding is not supported by any evidence, and hence, any inference that there

was a present consideration for the payment to Appellees is completely without foundation. In addition to this it is submitted that if the Court had permitted testimony on this subject, Appellant would have had the right to cross-examine and also to rebut any such testimony. However, the Court dismissed the entire subject matter as unworthy of consideration. Therefore, any finding on the subject not only lacks supporting evidence but is surprising to say the least.

II. THE DISTRICT COURT ERRED IN FINDING THAT APPELLEES DID NOT KNOW NOR HAVE REASONABLE CAUSE TO BELIEVE THAT MECHANIX, INC., WAS INSOLVENT AND IN CONCLUDING THEREUPON THAT THE PAYMENT BY MECHANIX, INC., OF $1500.00 EACH TO APPELLEES WITHIN FOUR MONTHS FOR BALANCE OF PAST DUE SALARY WAS NOT A PREFERENTIAL PAYMENT BY SAID MECHANIX, INC.

The Court made the following findings of fact (T.R. p. 8):

> "(4) That at the time the said defendants rereceived the said payments the defendants did not know, nor did the said defendants have reasonable cause to believe that the said Mechanix, Inc., was insolvent";

and concluded therefrom (T.R. p. 9):

> "(1) That the payment by Mechanix, Inc., the bankrupt herein, of the sum of $1,500.00 to each of the said defendants, which said payment was made prior to the filing of the petition of bankruptcy against the said Mechanix, Inc., was not a preferential payment by the said Mechanix, Inc., to the said defendants made within four

> months prior to the filing of bankruptcy and that the said trustee in bankruptcy is not entitled to recover from the defendants the sum of $1,500.00 from each of the said defendants."

This finding and conclusion raise the really important questions in this appeal. Appellant contends that, as a matter of law, the finding is erroneous, and hence, the conclusion must fall. The argument will be divided into two parts.

(1) The bankrupt was insolvent at the time Appellees received payment on past due indebtedness.

The *undisputed* facts show that the payments were made to Appellees on March 8, 1953 and that the involuntary petition in bankruptcy upon which Mechanix, Inc. was adjudicated a bankrupt was filed on March 13, 1953. Appellant's witness, Samuel Mendelson, Certified Public Accountant, prepared a balance sheet of the bankrupt "(Plaintiff's Exhibit 1)" which reflected its condition at the time the payments were made. It had a capital deficit of $33,955.75. After taking into consideration certain items that might constitute credits, there was still a capital deficit. Appellees endeavored to overcome their own records by showing that, although their books set up accounts receivable of $150,560.06, (Plaintiff's No. 1) their bankruptcy schedules listed them at $203,720.21. The difference was based on claims for extras on completed jobs for the United States Government. However, Appellees were unable to substantiate their right to extras on the basis of any agreements with the United States Government. They

admitted that to be able to claim extras a written authorization would be required which they did not have (T.R. p. 69). Consequently, they had no definite agreement upon which a claim could be based.

The testimony of Peter Hunt, the attorney assigned by trustee in bankruptcy to evaluate and process various claims of the bankrupt against the Government, was that the greatest recovery that could be received on these claims would be between $23,000.00 and $23,500.00 (T.R. p. 84). These claims are far below the amount that would have rendered the bankrupt solvent. Thus, it appears definite and certain that the bankrupt was insolvent on March 8, 1953 when payments to Appellees were made. The adjudication by the Court of bankruptcy on a petition filed just *five days later* would certainly support this conclusion.

(2) Appellees did have reasonable cause to believe the bankrupt to be insolvent when the payments were received.

The trustee in bankruptcy may avoid a preference if the creditor had reasonable cause to believe that the debtor is insolvent.

Section 60(b), 11 U.S.C.A. 96(b), of the Bankruptcy Act provides as follows:

> "b. Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent."

Some Courts have confused the words used in the above quoted portion of 60(b) "reasonable cause to

believe that debtor is insolvent" with the words "actual knowledge". The Act only provides that the creditor have reasonable cause to believe the debtor to be insolvent. To quote from one of the outstanding texts on bankruptcy:

> "Knowledge of insolvency is not necessary, nor even actual belief thereof; all that is required is a reasonable cause to believe that the debtor was insolvent at the time of the preferential transfer. *A creditor has reasonable cause to believe that a debtor is insolvent when such a state of facts is brought to the creditor's notice respecting the affairs and pecuniary condition of a debtor, as would lead a prudent business person to the conclusion that the debtor is insolvent.*" (Italics ours.)
>
> *Collier on Bankruptcy,* 14th Ed. Vol. 3, p. 989, sec. 60.53.

Thus, if the facts are sufficient to put a prudent business person on notice, he is chargeable with notice of all the facts which reasonably diligent inquiry would leave disclosed.

> *Collier on Bankruptcy,* 14th Ed. Vol. 3, page 989, sec. 60.53.

The Appellees were the president and secretary of the corporation as well as principal shareholders, directors and operating managers. They were in far better position than any other creditor to know the financial condition of the corporation. They knew the corporation did not have enough cash for their operations (T.R. p. 55; pp. 59-60). They were endeavoring to raise capital to continue. They didn't have

enough cash to pay their back salaries in full, and when they finally decided to take them on March 8, 1953, there was an overdraft at the bank. They owed other creditors at the same time but made no payments to them. There were meetings at the Board of Trade (T.R. p. 93). Yet, these Appellees, the managing operators, officers, directors and main shareholders claim to know nothing about the company's solvency? Who would, if they didn't? They are *presumed* to have this knowledge.

Matter of W. A. Silvernail Co., 218 Fed. 978, 33 Am. Br. 59;

Irving Trust Co. v. Roth, D.C., N.Y., 48 F. 2d 345;

Cohen v. Tremont Trust Co., (D.C., Mass.) 256 Fed. 399, aff'd 263 F. 81;

New York Credit Men's Ass'n. v. Hasenberg, (D.C., N.Y.), 26 F. Supp. 877 aff'd 107 F. 2d 1020;

In re Plant, 148 Fed. 37.

The chief officers of a corporation are charged with knowledge of the corporation activities. Appellee, Morrow, admitted that monthly statements were prepared by the corporation and that the operating statement for February, 1953 (Plaintiff's Exhibit 2), the month just prior to the filing of the petition in bankruptcy, showed a net deficit for the month of $9663.12 (T.R. p. 64). Yet, Appellees claim they did not know what their records would disclose.

If the managing officers and directors are not chargeable with knowledge of the conditions of their

company, how could anyone ever be held to any knowledge of a corporation's affairs? As a matter of fact, Appellant is satisfied that even the Court below felt that the Appellees had reasonable cause to believe they were insolvent but mistakenly didn't feel that this was a proper type of preference case (T.R. p. 91).

> "The Court. I am satisfied they must have felt conditions were getting tight, and they took the money, whether it amounted to a legal status recovery, but with knowledge they were insolvent and with interest to actually prefer themselves." (T.R. p. 91.)

The Court also seemed to feel that this case was not like the usual preference case.

> "The Court. Well I will think it over for a day or two. I don't think much of the case Mr. Anixter; most cases of preference are where a creditor comes in and gets the pay in preference against other creditors." (T.R. p. 93.)

It seems rather strange that the Court feels that officers and directors of a corporation on whom creditors have to rely in their business dealings are entitled to take advantage of their position and knowledge and fill their own pockets at the creditors' expense. It is also hard to understand how a Court can make a finding that Appellees did not have reasonable cause to believe the bankrupt to be insolvent in view of the Court's statement and the undisputed evidence quoted above.

For the foregoing reasons the trustee contends that the findings of the trial Court (T.R. pp. 7-9) are

not only unsupported by the evidence adduced but are also inconsistent with the Court's own "oral findings" as quoted above. Apparently, the trial Court labored under the misapprehension that because Appellees, although with reasonable cause to believe the bankrupt's insolvency received the payments in question under conditions which would be preferential to a creditor who was an officer employed by the bankrupt corporation, such payments were not recoverable by the trustee under section 60(b) of the Bankruptcy Act. We feel that the purpose of the preference law is to prevent a depletion of the insolvent debtor's estate by transfers to any creditors who have either knowledge of or reasonable cause to believe in the debtor's insolvency at the time of receipt of such payments. We believe that such recoveries should be had, regardless of the amount involved, and that *to condone the trial Court's judgment in this case would be to encourage, rather than discourage, corporate officers, with knowledge of a failing business, to withdraw as much of the corporation's cash prior to bankruptcy as their back salaries or other personal claims as creditors could possibly permit.* This is not consistent with the rights of creditors generally which the Bankruptcy Act is designed to protect. For these reasons we believe the trustee in bankruptcy must bring actions such as this even though the amounts involved may individually be small, because when added together, they would substantially increase the fund to which general creditors could look for recovery on their claims.

CONCLUSION.

Therefore, it is respectfully submitted that the judgment of the District Court should be reversed because the payments made by the managing officers to themselves on account of back salaries at a time when the corporation was insolvent were made with the presumptive knowledge as well as reasonable cause to believe the corporation was insolvent and were preferential within the meaning of section 60(b) of the Bankruptcy Act.

Dated, San Francisco, California,
December 21, 1956.

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